United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74—1537

United States Court of Appeals

FOR THE SECOND CIRCUIT
DOCKET NO. 74-1537

RENEE SLADE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

EDWARD E. ODETTE,
Plaintiff, Appellee,
against
SHEARSON, HAMMILL & CO. INC.,
Defendant, Third-Party Plaintiff, Appellant,
against
NATIONAL BANK OF NORTH AMERICA,
Third-Party Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

REPLY BRIEF FOR DEFENDANT, THIRD-PARTY PLAINTIFF, APPELLANT

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Defendant, third-party plaintiff, and appellant Shearson, Hammill & Co. Inc. ("Shearson") submits this reply brief in further support of its appeal from an order of the United States District Court for the Southern District of New York

denying its cross-motion for partial summary judgment as a matter of law. This reply brief will discuss the arguments in the appellee's brief and in the brief filed by *amicus curiae* Salomon Brothers ("Salomon"). The court below held that Shearson had to use adverse nonpublic information for the benefit of its customers by prohibiting its salesmen from soliciting securities purchases which were justified by favorable public information.

No useful purpose would be served by restating the facts at length here. However, both appellee Slade and *amicus* Salomon have done such peculiar things to the facts in the record that a short recitation is necessary. Shearson was the investment banker for Tidal Marine International Corporation ("Tidal Marine" or "Tidal"). As a matter of internal policy, Shearson does not recommend the securities of investment banking clients. [Bogardus Aff., para. 10, JA at A-28]. Hence, Tidal Marine was never put on Shearson's Master Buy List, which is the only method of making a firm recommendation. On the contrary, all internal wires mentioning Tidal Marine contained the following legend:

> "This wire should not be construed as an endorsement or recommendation of the Company's securities." [Bogardus Aff., Exhibits "B", "C", "D", and "E" (Exhibit "F" contains a similar legend but has a slightly different text); JA at A-35, A-37, A-39, A-40, and A-41].

Because Shearson does not recommend the securities of any investment banking clients but does require investment executives who may be interested in a client to know the fundamentals of the company, the firm routinely sends wires to the sales force containing verbatim quotations of public information. [Bogardus Aff., para. 26; JA at A-31-A-32]. In this way, Shearson transmitted to its investment executives all company press releases, good news or bad. For example, the wires, dated October 26, 1971 and August 2 and 11, 1972, quote Tidal press releases which disclosed a

30% decline in world shipping rates, a reduction in the charter rates on Tidal's charters, and Tidal's serious cash shortage". [Bogardus Aff., Exhibits "B", "E", and "F"; JA at A-35 and A-40-A-41].

The ministerial act of preparing the wires was performed by a variety of Shearson personnel [*See,* Bogardus Aff., Exhibits "B", "C", and "D"; JA at A-35, A-37 and A-39]. Each wire about Tidal Marine plainly states in the first sentence that it is merely a reproduction of a Tidal press release. [Bogardus Aff., Exhibits "B", "C", "D", "E" and "F"; JA at A-34, A-36, A-38, A-40, and A-41]. Prior to transmission, all wires are reviewed by the Corporate Finance Department to assure that they are based entirely on public information. [Bogardus Aff., para. 26; JA at A-32].

Shearson's registered representatives are required by law to have a reasonable basis for soliciting the purchase of any security. In addition, they must use only publicly available information in determining whether or not to solicit a transaction. The firm's requirement that the executives rely on these wires insures both that the representative makes his individual recommendations only on the basis of public information and that his state of knowledge about the company is as current as the law permits.

ARGUMENT

The policy underlying Section 10(b) of the 1934 Act and Rule 10b-5 prohibited Shearson from using nonpublic information to benefit its customers. Slade, however, suggests that Shearson should have used nonpublic information to send a no solicitation wire. This conduct would violate the securities laws, would offer minimal protection to most of Shearson's customers, would create the possibility for significant abuses of inside information, and would create a significant enforcement problem where none should exist. (Point I).

In its *amicus* brief, Salomon advocates the adoption of its own policy but leaves that policy in a very ill-defined state. In any event, Salomon's procedures are not properly before this Court because they are not part of the record. In addition, Salomon's policies and procedures, which appear to differ substantially from Shearson's, are the subject of class actions now pending against Salomon in the Southern District of New York. Their propriety ought to be litigated in those cases (Point II).

POINT I

The Federal Securities Laws Precluded Shearson From Using Nonpublic Information For the Benefit of Its Own Customers

The federal securities laws do not insure members of the investing public against loss. Instead, they are intended to give investors "equal access to material information". *SEC* v. *Texas Gulf Sulphur*, 401 F.2d 833, 847-48 (2d Cir. 1968), *cert. denied*, 404 U.S. 1005 (1971), *reh. denied*, 404 U.S. 1064 (1972). This Court emphasized that goal in *Crane Company* v. *Westinghouse Airbrake Company*, 419 F.2d 787, 794 (2d Cir. 1969), when it quoted and adopted the following language from the House Report on the 1934 Act:

> "To insure to the multitude of investors the maintenance of fair and honest markets, manipulative practices of all kinds on national exchanges are banned. . . . Legitimate investors desire to buy at as low a price as possible and to sell at as high a price as possible, and *honest markets are made by the balancing of investment demand and investment supply.*" [H.R. Rep. No. 1383, 73d Cong., 2d Sess. at 11 (1934); emphasis supplied].

The court below initially relied on a single word in the *Texas Gulf Sulphur* opinion, the word "recommending"

[Mem. Op. at 3; JA at A-52]; and appellee Slade continues to rely on this argument [Slade Br. at 11-12]. In certifying the pending question to this Court, however, the District Court did not adhere to its original view:

> "[I]t must be noted at the outset that the question in respect of which certification is sought is apparently one of first impression. Neither the case on which this court principally relied in disposing of the summary judgment motion, *SEC* v. *Texas Gulf Sulphur Co.* . . . nor any other case cited by plaintiffs involved the same combination of investment banking and brokerage functions as does the case at bar. Nor does any case cited by the parties concern a broker who advised its customers to take action *inconsistent* with the inside information it possessed." [Mem. Op. on Cert. at 3, JA at A-58-A-59; citation omitted; emphasis in original].

The passage quoted by the District Court, which proscribes "recommending" securities while in possession of favorable, nonpublic information, is a specific application of the general prohibition against using nonpublic information for securities transactions. This Court held that an insider with favorable nonpublic information could violate Rule 10b-5 in a number of ways: he could purchase securities himself, he could give the nonpublic information to others, or he could *recommend* to others that they purchase. In the present case, the solicitations were based on public information, which was inconsistent with the alleged nonpublic information. Most commentators have disagreed with the District Court's application of this fragment to the facts in the present case. Penn, Should Underwriters Disclose "Inside" Data to Stock Investors?, *Wall Street Journal* at 1 (September 16, 1974); Comment, Securities Regulation—Broker-Dealers, 27 *Vand. L. Rev.* 815, 821-23 (1974); Fleischer, Inside Information: How Solid Are "Walls"?, *Institutional Investor* at 31 (May 1, 1974); Gillis, Inside Informa-

tion: Are Guidelines Possible?, *Financial Analysts J.* at 89 (May-June 1974); Bernstein, Securities-Class Actions, *New York L. J.* at 1, 4 (January 28, 1974); and, *see also,* Harfield, *Texas Gulf Sulphur* and Bank Internal Procedures, 86 *Banking L. J.* 869, 872-73 (1969). In analyzing the District Court's opinion, one commentator has written:

> "The instant case . . . differs from *Texas Gulf* . . . in two critical respects. First, unlike the recommendations made by insiders in the earlier case, the recommendation here was inconsistent with the confidential information. In effect, defendant is being penalized for its good-faith effort to comply with *Texas Gulf* . . . by adopting a policy prohibiting free flow of confidential information within the firm. Secondly, in *Texas Gulf* . . . the individuals making the recommendations knew of the inside information; here, defendant's policy was intended to prevent the material, adverse information about Tidal Marine from leaving the investment banking department." [27 *Vand. L. Rev.* at 822-23].

The Commission's major Statement of Policy on this question, *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.,* Sec. Ex. Act Rel. No. 34-849, CCH Fed. Sec. L. Rptr. ¶ 77,629 (Exhibit "A") (1967-69 Transfer Binder) (November 25, 1968), supports Shearson's position. That Statement restrained Merrill Lynch employees from using nonpublic information and "any conclusions based thereon" except for underwriting purposes. [CCH Fed. Sec. L. Rptr. ¶ 77,629 at 83,351]. Appellee Slade argues that the Statement precludes "disclosing information received in connection with an underwriting"; and that, therefore, the distribution of a conclusion prohibiting solicitation is not just permitted, it is required. [Slade Br. at 14]. This argument cannot be serious. Nonpublic information is nonpublic information subject to the strictures of the federal securities laws no matter how it is acquired.

To justify its reading of *Merrill Lynch,* appellee edits beyond recognition a passage from the Commission's opinion:

> "[I]n *Merrill Lynch* the Securities and Exchange Commission condemned nondisclosure of adverse material facts where:
>
> '. . . registrant was affecting purchases of the stock for . . . customers to whom the adverse information was not available.[8]' (CCH Fed. Sec. L. Rep. at p. 83,349).
>
> In Footnote 8 above, the Commission said:
>
> 'Disclosure by registrant of the nonpublic information . . . would be likely to discourage purchases by such customers. . . .' (Id.)
>
> a proposition which the Commission viewed with favor." [Slade Br. at 14].

When the language replaced by elipses is reinserted, the quotation, in fact, supports Shearson:

> "Disclosure by registrant of the nonpublic information to all of its customers would not have cured the violation of the anti-fraud provisions. While it would be likely to discourage purchases by such customers, it would tend to induce sales or short sales by them with consequent unfairness to members of the investing public who purchased Douglas stock without knowledge of the information." [CCH Fed. Sec. L. Rptr. ¶ 77,629 at 83,349-50, footnote 8].

Salomon interprets the Commission's *Merrill Lynch* statement as requiring brokerage firms to adopt a three part policy: an information segregation or "wall" policy, a prohibition against soliciting transactions in the securities of investment banking clients, and a procedure for terminat-

ing recommendations if they become inconsistent with the firm's nonpublic information. [Salomon Br. at 19-20]. Shearson, of course, supports the first of these conclusions; but as far as the second and third inferences are concerned, there is no support whatsoever for Salomon's reading of *Merrill Lynch* either in that opinion or in subsequent Commission pronouncements.

Appellee and Salomon suggest that Shearson should have instructed its investment executives to discontinue soliciting when it learned of Tidal's undisclosed difficulties, i.e., send a no solicitation wire to its retail sales force. [Slade Br. at 8; Salomon Br. at 20].

Were Shearson to have acted in the manner prescribed by plaintiffs, it would have used nonpublic information to conclude that Tidal Marine was short of cash and then would have used that conclusion to issue an order prohibiting solicitation of purchases of Tidal securities. Only by using nonpublic information selectively could Shearson have spared appellee a loss on the investment in Tidal.

But a broker may not withdraw even a firm-wide "buy" recommendation on the basis of inside information, *a fortiori* Shearson could not have prohibited random solicitation by its representatives. Complaint, *SEC* v. *Celanese Corp.*, 74 Civ. 3053, para. 13 (S.D.N.Y. 1974); Complaint, *SEC* v. *Bausch & Lomb, Inc., et al.*, 73 Civ. 2458, para. 25 (S.D.N.Y. 1973); Gillis, *Bausch & Lomb* and Analytical Judgment, *Financial Analysts J.* at 10, 13 (May-June 1972); Interview with SEC Chairman, *Barron's* at 5 (April 9, 1973); Sandler and Conwill, *Texas Gulf Sulphur;* Reform in Securities Market Place, 30 *Ohio St. L. J.* 225, 269-70 (1969); Comment, Securities Regulation—Broker-Dealers, 27 *Vand. L. Rev.* 815, 820-21 (1974); Painter, Inside Information: Growing Pains for the Development of Federal Corporation Law, 65 *Colum. L. Rev.* 1361, 1388 (1965); City Code, Salomon Br. at 24; Companies Bill, Salomon Br. at 25; and N.Y.S.E. Circular, Salomon Br. at

20. Instead, the firm should continue its public posture without change pending the outcome of efforts to force disclosure by the company. *In the Matter of Investors Management Co., Inc., et al.*, Sec. Ex. Act Rel. No. 34-9267, CCH Fed. Sec. L. Rptr. ¶ 78,163 (at 80,552) (1970-71 Transfer Binder) (July 29, 1971) and Interview with SEC Chairman, *supra*, at 5. One commentator has concluded:

> "There is some evidence, moreover, that the SEC regards the withdrawal of a recommendation after receipt of inconsistent inside information to be violative of Rule 10b-5 . . . [A] recent complaint . . . charged that Faulkner Dawkins had illegally removed Bausch & Lomb from its buy list and passed the inside information to certain brokerage customers before it was publicly disclosed. *Apparently, the rationale underlying the first allegation is that withdrawal of a recommendation in these circumstances is tantamount to actual disclosure of the adverse information to customers who have access to the buy list.*" [Comment, *supra*, 27 *Vand. L. Rev.* at 820-21; footnote omitted; emphasis supplied].

As a practical matter, a no solicitation wire would provide no protection for the customer whose purchase was solicited prior to the no solicitation wire but who did not give his order until afterward. Even under Slade's theory, the Shearson registered representative could not disclose to these customers the suspension of solicitations, nor could he take a position on the stock in response to a direct inquiry by them. [Slade Br. at 8]. Hence, these customers and those who purchased prior to the no solicitation wire would not be helped by the wire. Penn, Should Underwriters Disclose "Insider" Data to Stock Investors, *Wall Street Journal* at 1 (September 16, 1974); Comment, Securities Regulation—Broker-Dealers, 27 *Vand. L. Rev.* 815, 824 (1974); and Bernstein, Securities-Class Actions, *New York L. J.* at 4 (January 28, 1974).

In addition, the no solicitation wire would create numerous enforcement problems where none now exist. The Commission purposefully precluded the dissemination of conclusions based on nonpublic information in *Merrill Lynch*. If word of a no solicitation wire reached other brokers, given Shearson's role as investment banker for Tidal, the suspension of solicitations would trigger a market reaction. Because the public information about Tidal Marine was optimistic at the time of plaintiff's purchases, investment analysts who learned of the suspension might have incorrectly concluded that the action was undertaken because of additional favorable but undisclosed information, thus prompting purchases. Penn, *supra, Wall Street Journal* at 1 (September 16, 1974). At the same time, Tidal Marine was a newly formed, unlisted company; the issuance of a no solicitation order by such an issuer's investment banker frequently prompts waves of sales. Leiman, *First Annual PLI Institute on Securities Regulation* at 327-28; O'Boyle, Conflicts of Interest and the Regulation of Securities, 28 *Bus. Law.* 545, 573 (1973); and O'Boyle and Fleischer, *Fourth Annual PLI Institute on Securities Regulation* at 266 (1973).

Slade relies on three opinions to support the argument that Shearson should have sent a no solicitation wire, *Van Alstyne Noel and Co.*, 33 SEC 311 (1952); *Black* v. *Shearson, Hammill & Co.*, 72 Cal. Rptr. 147 (Ct. App., 1st Div. 1968); and *Matter of Cady Roberts & Co.*, 40 SEC 907 (1961). These decisions are inapposite to the issue at hand; they are factually distinguishable; and to the extent that they are critical of the segregation or "wall" policy, they no longer state controlling law.

In *Van Alstyne Noel, supra,* the firm predicted a great future for its client while loaning it money to continue operation, selectively disclosed adverse data, and made intentionally false statements to banks [33 SEC at 316, 323-24]; Shearson merely transmitted verbatim Tidal press releases, a practice the Commission found unobjectionable

in *Van Alstyne* [33 SEC at 318, 327-28]. In a subsequent proceeding against the same respondent, *Van Alstyne, Noel & Co.*, Sec. Ex. Act Rel. No. 34-8511, CCH Fed. Sec. L. Rptr. ¶ 77,656 (January 31, 1969), the Commission applied the holdings in *Texas Gulf Sulphur* and *Merrill Lynch* to suspend the firm's license because it upgraded its recommendation of an investment banking client's securities on the basis of optimistic nonpublic information "[p]rior to any public disclosure of the favorable developments. . . ." (at 84,435).

The partner involved in *Black, supra,* did not maintain his prior public posture when informed of unfavorable nonpublic information: he stopped soliciting customers to buy the stock in question, sold his personal holdings "at a high profit", and liquidated his friends' debentures for ten times their face value [72 Cal. Rptr. at 159-160; *see also,* Leiman, Pollack, and Whitney in *First Annual PLI Institute, supra* at 333-35, 351 (1969)]. To the extent that the *Black* decision is contrary to Shearson's position here, the commentators uniformly suggest that it not be followed. *E.g.,* Leiman and Whitney, *First Annual PLI Institute, supra* at 327, 351 (1969) and O'Boyle, *Third Annual PLI Institute on Securities Regulation* at 486-87 (1972). One author has declared:

> "Hopefully, the *Black* case, to the extent that it may represent a rejection of the 'isolation' technique, will not be followed." [O'Boyle, *Third Annual PLI Institute, supra* at 486-87].

The insider in *Cady, Roberts, supra,* would have avoided censure had he continued his business without reference to the nonpublic information, which led him "to sell before the expected public announcement all of the . . . shares remaining in his discretionary accounts, contrary to his previous moderate rate of sales" [40 SEC at 916]. The Cady employee in question also embarked on an extensive program of short sales [*Id.; see also,* Comment, The *Cady*

Roberts Doctrine, 30 *U. Chi. L. Rev.* 121, 140-41 (1962); Daum and Phillips, The Implications of *Cady, Roberts,* 17 *Bus. Law.* 939, 955-56 (1962); and Painter, *Federal Regulation of Insider Trading* at 141 (1968)]. As the Commission held in *Cady, Roberts*:

> "Even if we assume the existence of conflicting fiduciary obligations, there can be no doubt which is primary here. On these facts, clients may not expect of a broker the benefits of his inside information at the expense of the public generally." [40 SEC at 916].

Shearson's position on the requirements of the securities laws remains unquestioned. Its procedures faithfully implemented the Commission's guidelines and none of its conduct forfeited the legal protections which these procedures should provide. Neither Slade nor Salomon offer this Court any authority rejecting Shearson's reading of the securities laws or a more effective procedure for safeguarding nonpublic information.

POINT II

Salomon's Policies Should Be Litigated in The Pending Lawsuits Against It

In its brief Salomon introduces its own partially described procedures and asks, in practical effect, that this Court validate these inadequately described procedures while passing on the validity of Shearson's policies. This is not the proper role of an *amicus curiae*. *Moffat Tunnel Improvement Dist.* v. *Denver and S. L. Ry. Co.*, 45 F.2d 715, 722 (10th Cir. 1930) and *United States* v. *Winkler-Koch Engineering Co.*, 209 F.2d 758, 759 (Ct. of Cus. 1953). As the Tenth Circuit has held:

> "Briefs are received from *amici curiae* to aid the court in disposing of issues before the court; friends

of the court cannot introduce new issues . . . ." [*Moffat Tunnel Improvement Dist.* v. *Denver and S. L. Ry. Co.*, *supra* at 722].

Salomon is a defendant in a number of consolidated cases brought in the Southern District of New York, *Shapiro et al.* v. *Consolidated Edison Co. et al.*, 74 Civ. 1906 (S.D.N.Y. 1974). The complaints allege that Salomon, as a principal underwriter for a Consolidated Edison bond offering, failed to disclose prior to unsolicited purchases by the class that Con-Edison was suffering a "severe cash shortage" and that the utility was omitting a quarterly dividend. [*Shapiro* Comp., para. 9(b)]. The plaintiffs in those cases rest their claims on the precise conduct which *amicus* repeatedly argues is permissible as long as the nonpublic information remains isolated in the firm's investment banking department. [Salomon Br. at 11, 13, 14-15, and 26-27]. Because the issue on the pending appeal involves only solicited purchases [Mem. Op. at 4; JA at A-53], Salomon's arguments are irrelevant. In addition, Salomon frequently states that its isolation policy is materially different from Shearson's. [*E.g.*, Salomon Br. at 5 and 19-20]. The propriety of Salomon's procedures ought to be litigated in Salomon's pending lawsuits.

In addition, this Court should not consider Salomon's policies because they are not a matter of record in this appeal and references to facts not included in the record on appeal are strictly proscribed by this Court. *Dictograph Products Co.* v. *Sanitone Corp.*, 231 F.2d 867 (2d Cir. 1956); *Bono* v. *United States*, 113 F.2d 724, 725 (2d Cir. 1940); *cf.*, *Chasins* v. *Smith, Barney & Co.*, 438 F.2d 1167, 1174-77 (2d Cir. 1970) (Friendly, J. dissenting).

Having no litigated record recording Salomon's procedures, the Court is left only with an incomplete description of its "restricted list", which supposedly has three vague purposes: "to prevent violations of Rule 10b-6 . . ., to assure that inside information is not used improperly;

and . . . to assure that the firm does not make recommendations contrary to inside information". [Salomon Br. at 5]. Salomon indicates only that its list assures that "no department" violates its non-recommendation policy. Salomon does indicate that it deals only with block positioners and institutional traders [Salomon Br. at 4] and that it will execute unsolicited orders for its customers while the firm's investment bankers have inside information inconsistent with the customer's order. [Salomon Br. at 26-27]. Those trades are scarcely as mechanical as Salomon represents them to be. Securities and Exchange Commission, 4 *Institutional Investor Study* 1537, 1585 (1971) and Securities and Exchange Commission, Sec. Ex. Act Rel. No. 8791 at 4 (1969), CCH Fed. Sec. L. Rptr. ¶ 77,771 (at 83,778) (1969-70 Transfer Binder) (1969). The Commission has described the procedures involved in a block trade as follows:

> "[T]he definition of a 'block' transaction [is one] in which a member firm . . . reasonably concludes that it is in the interest of the customer to search and negotiate for a matching interest on the other side of the market (including negotiating as principal with the customer) rather than to accept or submit a bid or offer in the ordinary course of the auction market." [Rel. 34-8791, *supra* at 4, CCH Fed. Sec. L. Rptr., *supra* at 83,778].

Of course, Salomon says nothing about that aspect of its business or how this Court should consider those facts when considering the issues on the pending appeal.

Salomon raises legal issues and asserts vague facts not properly before this Court on this appeal. This is not the kind of "assistance" an *amicus curiae* should be rendering to the Court; and the *amicus* brief should, therefore, be given little weight on the issues at hand.

CONCLUSION

Neither the position on the law nor the policies advanced by Slade and Salomon justify a rejection by this Court of the procedures suggested by the Commission and followed by Shearson. Appellant attempted to compel disclosure of Tidal's cash shortage and ultimately succeeded. In the interim, Shearson's public posture remained unchanged until the company released the information. This conduct was in strict compliance with the guidelines established by the Commission.

This Court should answer the question certified by the District Court in the negative.

Respectfully submitted,

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